

~~CONFIDENTIAL~~

(b)(3)

THE SOVIET ECONOMY IN PERSPECTIVE

The Soviet economy, the second largest in the world, has grown since 1950 from about one-third to more than one-half the size of the US economy. The basic tenets of Soviet growth strategy have been:

- o a high rate of investment in heavy industry, fuels and power, and construction; a lower rate in consumer goods and agriculture;
- o emphasis on modern, capital-intensive technology in the favored sectors; use of old-fashioned, labor intensive methods in the low priority sectors;
- o large expenditures on education and science to raise the technical skills of the population;
- o acquisition of advanced Western technology and equipment in exchange for raw materials.

Making and Implementing Economic Policy

This is a "command economy". Basic economic decisions are made by central administrative fiat rather than in the market place:

- o The Politburo of the Communist Party makes the major economic decisions.
- o A huge bureaucracy -- headed by the Council of Ministers -- sets specific output goals, allocates manpower and materials, fixes wages and prices, and regulates incentives.
- o Lower down, state-owned industrial facilities and collective farms translate the economic plans into action.

The Politburo -- the highest executive arm of the Central Committee of the Communist Party -- acts much like the board of directors of an enormous conglomerate. As chairman of the board, General Secretary Gorbachev presides over weekly Politburo meetings where decisions on general economic priorities are reached. It is the Politburo that decides on the division of resources between military and civilian use and the distribution of investment between industry and agriculture.

The Council of Ministers -- the government's highest executive body -- can be likened to a senior management team

~~CONFIDENTIAL~~

of the conglomerate. The new Chairman of the Council, Nikolay Ryzhkov, has final responsibility for determining the output of all major commodities, distributing resources, and ensuring that plans are fulfilled. The organization under the Council includes the State Planning Committee (Gosplan), more than 50 functional economic ministries (such as ferrous metallurgy, foreign trade, and agriculture), and a host of state committees and main administrations concerned with finance, prices, supply, and the like. The State Planning Committee is now working on the Twelfth Five-Year Plan for 1986-90.

Strengths

The Soviet economy has great crude economic strength, based on a wealth of natural resources, a labor force half again as large as that of the United States, a large and growing stock of industrial facilities, and an unchallenged leadership dedicated to continual expansion of industrial and military might. Growth has been maintained by the brute force method of allocating about one-third of national output to investment and by extracting as large a work force as possible out of the populace. This growth formula has enabled the Soviets to amass an ever increasing arsenal of sophisticated weapons, to continually expand their industrial base, and to provide some increase in living standards each year.

Weaknesses

A number of persistent problems that have plagued the Soviet system for years have become particularly troublesome since the mid-1970s.

- o Low productivity and the declining efficiency of investment. Despite a growing volume of investment per worker, labor productivity in Soviet industry is only about half the US level. This is particularly serious since annual additions of men and equipment are becoming smaller, and productivity gains must be the future source of growth. An added difficulty is the gradual exhaustion of easily accessible natural resources and the rising cost of exploiting new resources, many located in remote and frozen areas of Siberia.
- o Technology gap. Although the latest technology is employed in some areas -- particularly in the defense and space industries -- technology in the civilian economy generally lags far behind that of the West. The Soviet system is particularly ineffective in moving new ideas and products from the research and development stage into full assembly-line

production. Moreover, Western equipment frequently is not as productive in a Soviet setting as it is on native ground. At the same time that the USSR is struggling to catch up, the United States, Western Europe, and Japan are forging ahead with still newer technology.

- o Rising consumer expectations. Though well-fed and clothed compared with past generations, Soviet consumers are increasingly aware of the disparity between Soviet and Western living standards. Consumer grievances are especially acute as to housing, long queues, and the poor quality of durables and other consumer goods and services.
- o Inefficient agriculture. Nearly one-fifth of the labor force is still employed on the farm; equipment is badly operated and maintained; and the cost of producing grain and meat is far above world market prices.

Most of these problems are rooted in the Soviet system of planning and management, which is too centralized and clumsy for effectively managing the increasingly complex economy. Central planning, for example, becomes more difficult as the number of links between producers, consumers, and suppliers multiplies.

The Soviet incentive system is especially ill-equipped to deal with today's problems. Although it was effective in maximizing physical output in the 1950s and 1960s when resources and raw materials were cheap and readily available, in recent years it has led to industrial bottlenecks, encouraged waste and mismanagement of resources, contributed to irrational investment decisions, retarded scientific technological innovation, and stimulated widespread corruption and illegal economic activity.

As a result of these weaknesses, Mikhail Gorbachev inherited a decade-old economic slowdown punctuated by harvest failures, industrial bottlenecks, labor and energy shortages, low productivity, and declining efficiency of investment. Part of the problem has been the result of external factors:

- o Harsh weather conditions that have depressed farm output.
- o Declining increments to the working age population that have led to labor shortages.
- o Rising costs and increasing difficulty of extracting and transporting energy resources and other raw materials, which have

exacerbated the squeeze on labor and capital resources and intensified the impact of bottlenecks already present in key sectors of the economy.

But the key source of the USSR's economic slowdown -- as Gorbachev himself has implied -- is systemic: existing methods of planning and management are more and more incapable of coping with a modern economy.

Economic Prospects Under Gorbachev

Since coming to power in March 1985, Gorbachev has moved forcefully to place his personal stamp on economic policy, telling managers that they must change the way they do business or "get out of the way". His frankness illustrates the strong emphasis he is placing on the need for competent personnel and for tougher standards of performance evaluation. He seems to have a clear understanding of the economy's problems and is determined to deal with them. Gorbachev has described the acceleration of economic growth as his major domestic goal and laid out a growth strategy that includes increasing the pace of scientific and technological progress, restructuring investment, reorganizing management and planning, and tightening economic discipline.

The key element in implementing this policy is to be the "re-equipping" of the economy with high-quality, technologically up-to-date machinery. This, he says, will require sharp increases in machinery production and a larger share of investment in machinery producing facilities. The other significant known components of his plans for dealing with the economy are essentially continuations of policies introduced in recent years, but not effectively implemented. These include vigorous application of Andropov's discipline campaign which waned under Chernenko, linking wages more closely to productivity, implementing Brezhnev's 1982 Food Program of which he was primary architect, providing more operational autonomy for enterprise managers, and sharply curtailing the powers of the ministries.

Gorbachev has indicated that a reorganization of the economic bureaucracy will be a major part of his strategy. In a June speech he suggested that plans for such a reorganization have now reached an advanced stage and that they include the creation of superministerial bodies, starting with agro-industrial and machine-building sectors. His speeches also suggest that these super-ministries will be restricted to "strategic" planning and leave operational control of enterprises in the hands of the managers on the scene.

Gorbachev's program could result in improved economic performance if vigorously pushed. Priority development of the food industry, for instance, coupled with greater attention to transportation and storage facilities, could considerably reduce the present enormous waste and spoilage

of agricultural produce. Moreover, the discipline campaign, which was evidently a significant factor in the economic upswing during Andropov's tenure, could again have a favorable impact on economic performance. Gorbachev is gambling that an attack on corruption and inefficiency, not radical reform, will turn the economy around. Although his approach is risky -- previous attempts to redirect investment resources and other economic initiatives generally have been frustrated by entrenched bureaucratic interests--his prospects for success should not be underestimated.

How much economic improvement occurs and how long it lasts will depend largely on whether Gorbachev can deal successfully with problems inherent in the economic system itself. He has not, for example, squarely addressed such problems as the arbitrary nature of Soviet prices, which prevent planners from making economically rational decisions, or the lack of sufficient consumer input into decisions on what to produce. Nor has he explained how, in a period of likely resource stringency, with investment to grow at an accelerated rate and defense likely to have a strong claim on resources, the consumer's needs can also be addressed.

There have been hints, however, in Gorbachev's past and recent speeches, and in the statements of some knowledgeable Soviet officials, that the General Secretary may eventually tackle some of these problems. In his Lenin Day Address in April 1983, for example, Gorbachev stressed the importance of greater reliance on prices as an economic lever. He returned to this theme in his June 1985 address to the Science and Technology conference, calling for a more decisive shift from administration to economic methods of regulating the economy. In the same address he also called for an end to "the domination of the consumer by the producer".

Gorbachev may well have decided to refrain from translating such vague expressions of support for controversial measures into specific proposals until he has fully formulated his plans and/or consolidated his political strength. A Soviet political commentator privately characterized Gorbachev's current approach as one of first adopting uncontroversial economic measures while simultaneously working on a long-range and more far-reaching program. Alternatively, Gorbachev may have refrained from bolder measures because he hopes that the steps he has already proposed will be sufficient to remedy the economy's ills. Indeed, he has made clear that he remains committed to the basic system of central planning. In either event, the

~~CONFIDENTIAL~~

6

political momentum he already enjoys augurs well for his future ability to take bolder steps, and the ambitious nature of the goals he has set increases the chances that he will have to do so. Nevertheless, he is likely to find that real improvements will be short-lived and limited so long as the system is kept intact.

Drafted by:

[REDACTED]

CIA

[REDACTED]

CIA

~~CONFIDENTIAL~~